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TAGS: PREL PGOV KDEM EUN EFIN BEXP EIND EAID XG
SUBJECT: STRUCTURAL FUNDS OFFER CENTRAL EUROPE MEANS FOR
WEATHERING ECONOMIC CRISIS

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¶B. BRUSSELS 280
¶C. BRUSSELS 134

¶1. (SBU) Summary and Introduction. Over the next four to six years, the ten Central European Member States that joined the EU since 2004 have the opportunity to avail themselves of some $223 billion (176.6 billion Euros) of EU Structural and Cohesion funds. These funds were established to advance European economic and social cohesion by investing in large-scale development programs for the EU's poorest regions. Approximately 35 percent of the EU budget from 2007-2013 is dedicated to these funds, which benefit the new member states. The new member states represent 20 percent of the EU's population and only 7 percent of the EU's overall GDP. Modeling experts in the European Commission maintain that these investments will raise GDP levels in the new member states on average by 3 to 5 percentage points above baseline by 2016. Many EU economists believe that the global economic slowdown is making these funds even more valuable to Central Europe because they will serve as a de facto stimulus plan in otherwise depressed markets. Still, the Central European member states need to overcome a range of obstacles in implementing these funds, including improving absorption and administrative capacities, warding off potential corruption, and contributing required matching funds.

¶2. (SBU) This cable is the fourth in a series (REFTELS) looking at how the Central European states that joined the EU since 2004 -- Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia -- commonly known as the CE-10, are faring within EU institutions. This cable examines the significant economic benefits available to the new member states in the current EU budgetary period. End summary and Introduction.

Structural and Cohesion Funds Defined

¶3. (SBU) There are tremendous economic disparities across the EU; a quarter of all EU regions have a GDP per capita of less than 75 percent of the EU average. EU Structural and Cohesion Funds were developed to minimize such disparities by redistributing approximately one third of the EU's budget -- largely contributed proportionally according to GDP from all member states -- to the poorest regions. These grants are provided in seven-year increments, often with a two-year grace period at the end, to member states to support projects that advance priorities established by the European Commission. The current 2007-2013 period prioritizes innovation and entrepreneurship, expanding a knowledge-based economy, and creating jobs.

¶4. (SBU) Structural Funds support three main objectives.

First is the "Convergence" objective, in which 82 percent of the funds are concentrated on promoting growth-enhancing conditions to lead to economic development. Second, the "Regional Competitiveness and Employment" objective, with 16 percent of the funds, supports innovation, sustainable development, and investment in human resources. Third, the remaining 2 percent is dedicated to the "European Territorial Cooperation" objective, which supports cross-border, transnational, and interregional cooperation projects.

¶5. (SBU) Whereas Structural Funds comprise the broader range of such grants, the Cohesion Fund supports projects specifically in the transport and environmental sectors in member states where gross national income per capita is less than 90 percent of the EU average. States eligible for the Cohesion Fund in the current period are Bulgaria, the Czech Republic, Estonia, Greece, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Portugal, Romania, Slovenia, and Slovakia. The European Commission has prioritized the following types of Cohesion Fund projects for 2007-2013: air, rail, river and sea transport, highway construction, water distribution and treatment systems, and clean urban transport networks. In a change from the 2000-2006 period, renewable energy projects can now be financed using the Cohesion Fund.

¶6. (SBU) Central European member states presented their lists of national priorities for these grants in documents called the "National Strategic Reference Framework," which outlines the projects needed in the poorest regions. The European Commission then negotiated and approved the specific programs, and determined the share of national and EU funds to be used to implement such initiatives. Stefaan Pauwels, an Economist with the European Commission responsible for

Central Europe, informed Poloff on 9 March that the co-financing percentages for the new member states were recently reduced from about 20 to 15 percent in an effort to make it easier for the new members to use these grants. Pauwels opined that this would also undercut arguments he often hears from the new member states that the co-financing requirement forces recipients to increase their budget deficits in the short term. Describing a strange logic in the Commission and the complex process of administering these funds, Pauwels pointed out that in some cases, the member state share of co-financing can actually come from other EU funds, such as those offered by other Commission initiatives.

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Funds Coming at Ideal Time, Given Economic Slowdown
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¶7. (SBU) Polish MEP Janusz Lewandowski, Vice Chair of the Committee on Budgets, told Poloff recently that the structural funds destined to the CE-10 are coming at a propitious time, because they constitute a natural anti-financial crisis package for these countries facing the global financial crisis. (By statue, the EU budget must balance, and therefore cannot have a stimulatory effect for the entire EU). In noting the ideal timing, Lewandowski asserted that the EU bureaucracy urgently needs to simplify the prepayment process -- the steps by which funds are transferred from the EU to the national banks of the member states. He argues that this area is especially important because it fills a liquidity gap for the recipient states. The vast majority of Structural Funds to Central Europe will be going to transportation infrastructure such as highways and rail construction and modernization, development of human capital through education improvements and training programs, communication investments, and investments in business and innovation; all these can spur job creation and investments during the financial crisis. Naturally, as Lewandowski noted, priorities vary from state to state. Poland, for example, needs to focus on highway construction, as it lags behind other EU member states in transportation infrastructure. Lewandowski noted that Poland will be

receiving the largest share of the EU's Structural Funds for Central Europe, about $86 billion (67 billion Euros), and possibly more through direct contributions to agriculture. He noted that Central European states are only now beginning to receive project funding for the 2007-2013 period, and this is because the new member states were late in submitting their National Strategic Reference Frameworks.

¶8. (SBU) In line with the priorities laid out by the European Commission, the Central European member states -- to varying degrees -- have selected transportation infrastructure, human capital, business and entrepreneurship, and balanced territorial development as among their top programs to receive Structural Funds in the current budgetary period. Jose Luis Robledo Fraga, the Head of the Unit overseeing the Baltic States in the European Commission's Directorate for Economic and Financial Affairs, told Poloff on 9 March that these types of initiatives are exactly the types of projects needed to reduce the economic and social disparities between Western and Central Europe. Robledo Fraga, agreeing with the ideal timing of these funds, told Poloff that the Central European states with non-Euro currencies that have experienced considerable depreciation, such as Hungary and Poland, will benefit in that the value of the Euro funded projects will now go further. Furthermore, whereas the European Commission had previously worried about structural funds causing Central European economies to overheat -- in which these massive cash influxes would cause demand and prices to rapidly rise with little effect on production -- Robledo Fraga viewed that as a less relevant concern in the current depressed market.

Commission Predicts Transformational
Effects in Central Europe . . .

¶9. (SBU) On 9 March, Poloff met with Jan in 't Veld, an Economist with European Commission's Directorate General for Economic and Financial Affairs, who is responsible for modeling the expected impact of EU Structural and Cohesion Funds. In 't Veld maintained that the EU Structural and Cohesion Funds will yield a transformational effect on the Central European member states. Describing his model, which is widely praised by EU officials, In 't Veld projects that EU Structural and Cohesion Funds will cause GDP levels in the new member states to rise, on average, between 3 to 5

percentage points over baseline projections by 2016. Discussing possible negative aspects of these funds, In 't Veld told Poloff he was concerned about their propensity to crowd out private capital in the new member states. Filip Keereman, Head of Unit for the Czech Republic, Poland, Romania, and Slovakia in the European Commission's Directorate for Economic and Financial Affairs, described an ongoing economic debate among Commission economists, regarding where to prioritize resource allocation. One group favors focusing on growth-leading sectors, with the expectation that development would emanate from those focal points. Another group favors spreading these investments throughout the countries in a bid to encourage more even development. Keereman himself favored the first approach, warning against a premature focus on wealth redistribution.

. . . Provided Recipients Overcome Absorption
and Administrative Challenges

¶10. (SBU) Dalia Grigonyte, a Desk Officer for Central Europe in the Directorate General for Regional Policy in the European Commission, recently told Poloff that the largest obstacle to maximizing the utility of these funds will be low absorption rates. While the new member states, on average, used 94 percent of the Structural Funds available to them

from 2004-2006, they only made use of 52 percent of the Cohesion Fund in the same period. Mission contacts point out that the Commission enforces considerably more oversight over the Cohesion Fund than Structural Funds, a likely explanation for the lower absorption rate of the former. Grigonyte judged that while generally the smaller Central European member states have done a better job at absorbing available funds, Bulgaria, Hungary, Poland, and Romania need to increase their rate of spending to achieve full absorption. She noted that it is natural for member states to accelerate their spending as they approach the end of the budgetary period.

¶11. (SBU) Poloff met on 3 February with Dr. Sabina Kajnc, a Research Fellow specializing on Structural Funds at the Center for European Policy Studies. While her conclusions note that Slovenia performed the best in terms of applying for and absorbing EU structural funds, its experience was not problem free. The amount of funds available to Slovenia tripled once it became an EU member in 2004, and Kajnc posited that Slovene officials were not prepared for this, and had not put much thought into the long-term projects Ljubljana would propose. Further complicating matters was the issue of absorption capacity, and this touches on three areas: 1) macroeconomic capacity, 2) the question of whether the government could come up with its required matching funds, and 3) administrative capacity, whether Slovenia had the local expertise needed to initiate, plan and execute such EU projects.

¶12. (SBU) Lewandowski conceded that no member state can make use of all available structural funds, but noted that concerted efforts need to be taken to avoid the appearance of failure in this regard. Echoing this point, Marek Evison, Foreign Policy Advisor to Joseph Daul, Chair of the European People's Party (Christian Democrats) and European Democrats, informed Poloff on 6 March that the main reason Central European countries failed to spend all the money allocated to them was poor administrative capacities. He argues that as a result, Central European member states could be hard-pressed to justify future requests for funding. Evison asserted that in the Polish example, the local level was of key importance; some mayors did a much better job than others at securing EU financing for their municipalities. He viewed central governments in the region as doing a generally poor job at coordinating the planning and disbursements of these funds.

¶13. (SBU) The European Commission is particularly wary of corruption in the administration of EU funds, especially instances of misuse in Bulgaria and Romania, according to economist Stefaan Pauwels. He noted Commission concern about the prospect of Structural and Cohesion Funds falling into the hands of organized crime in Bulgaria, or being lost to corruption. Although news of Bulgaria losing access to some $285 million (220 million euros) of EU funding in the agriculture sector dominates European media coverage, Pauwels pointed out that Romania also has some of its EU financial assistance frozen due to corruption concerns. The EU has established monitoring and auditing mechanisms to counter the potential misuse of EU funds, although the effectiveness of these safeguards is unknown. There is a widespread

perception among EU experts and some within the Commission that the current safeguards for Structural Funds, which have been relaxed in the current period to make it easier for member states to use the funds, could be insufficient to prevent corruption. Also, as the issue of where to spend these funds is a political one, there have been allegations of misuse and cronyism in Central Europe. Some EU policy experts warn that extremist political parties can be "purchased" into a governing coalition by giving them control of ministries responsible for overseeing EU Structural and Cohesion Funds.

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Opportunities Exist for European and U.S. Businesses

¶14. (SBU) Comment: Despite absorption, administrative and corruption concerns, the EU Structural and Cohesion Funds represent a significant transformational possibility for the Central European member states. These funds are likely to prove effective at stimulating jobs and long-term growth in the region, depite the global economic slowdown. Moreover, these funds represent a unique opportunity for European and U.S. businesses. U.S.-based firms are eligible to participate as partners in projects that receive EU Structural or Cohesion Funds, and supplies of U.S. origin are permitted. The only requirement is that the fund beneficiary establish a bank account in an EU member state. U.S. firms are advised to find a suitable European partner to interact with local regional authorities. U.S. subsidiaries located in the EU that are legally registered in a member state are considered "European firms," and are thereby fully eligible. Over time, as income levels in Central Europe rise, the region will become an even more attractive market for higher-end global goods and services. End comment.

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